Hong Kong Monetary Authority

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DOMESTIC LENDING

Key points:

- *Discussions with banks suggest that subdued demand has been the predominant factor behind sluggish loan growth. This was, in turn, associated with the downturn in the property market, which has traditionally been a main driver for both corporate and personal lending.*

- *Most of the banks we met indicated that they had relaxed their lending policies as the general improvement in economic activity had eased concerns about credit risks and strengthened borrowers' financial conditions. Lending rates have declined, most notably in respect of lending to large conglomerates and personal loan. Nevertheless, banks have remained cautious in lending to small- and medium-sized enterprises, and mainland-related entities, as high delinquency is still fresh in memory.*

- *Domestic lending has also been affected by some structural factors. In particular, the availability of renminbi funding has reduced the need for corporations to borrow from banks in Hong Kong to finance their operations in the mainland. Another major change has been an increase in open account trading, which has reduced demand for trade financing loans.*

- *Most banks do not consider equity market financing as a substitute for bank financing, as the IPOs have mostly been launched by firms in the technology sector which lacked a track record to apply for bank loans. Debt market financing is perceived to pose a bigger threat to traditional bank lending.*

- *Looking ahead, banks expected modest growth of loans in the absence of large-scale investment projects in the near future. Competition is expected to remain keen in mortgages and other personal lending. In the medium term, telecommunications sector is perceived to be a promising growth area. China's entry to WTO is also likely to bring along new investment opportunities and loan demand.*

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I. INTRODUCTION

While the Hong Kong economy has staged a strong V-shaped recovery since the second quarter of 1999, domestic lending has remained sluggish, and has only resumed mild positive year-on-year growth since August 2000. This is a puzzling phenomenon because in previous economic cycles, growth in domestic lending lagged behind the rebound in economic activity by only one to two quarters. With a view to obtaining a better understanding of the reasons behind weak loan growth and the business prospects, we have informally consulted several large and medium-sized banks, which are active in the domestic lending market. This paper reports the main findings from our discussion with banks. Where possible, the arguments are supplemented by statistics and information from other sources.

The rest of the paper is organised as follows: the next section examines briefly the historical patterns in loan growth and economic activity. Section III presents the banks' views on the main reasons leading to sluggish loan growth, including demand and supply side factors, structural changes in certain sectors, and competition from alternative funding channels. Section IV discusses the prospects of lending business, and section V concludes.

II. LENDING AND ECONOMIC ACTIVITY

Owing to the importance of bank lending as a source of financing for investment and trading activity in Hong Kong, the credit cycle used to track the economic cycle closely in the past. Regression analyses also suggest a strong historical relationship between domestic loans and GDP, with a lag of one quarter.[1] In the last economic downturn in 1995, domestic loans soon resumed strong growth as the economy staged a rebound. However, in the present cycle, while real economic activity grew strongly since mid-1999, domestic loans only returned to positive growth (year-on-year basis) since August 2000 (Chart 1).

A continued shrinkage of domestic loans for two years was unprecedented. Declines were observed across a broad spectrum of economic sectors, notably for trade financing, wholesale and retail, financial concerns, property development and investment. Within personal lending, growth in residential mortgages has remained positive, but has moderated significantly from the pre-crisis level (Chart 2). While the pace of decline in domestic loans moderated considerably over the course of 2000, and there was a mild increase was recorded towards the end of the year, the underlying tone appears to be weak.

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[1] Our regression results show that –

$$\underset{}{\ln \text{loans}} = \underset{(16.33)}{0.61 \ln \text{real GDP}_{(t-1)}} + \underset{(12.51)}{1.44 \ln \text{CPI}} - \underset{(-3.02)}{0.01 \text{ real interest rate}} + \underset{(2.51)}{0.004 \text{ time trend}}$$

(R^2 = 99.3%)

In other words, other things being constant, a 1% rise in GDP would lead to 0.6% rise in loans, 1% rise in consumer prices would lead to 1.4% rise in loans, and a 1 percentage-point rise in real interest rate (based on long-term measure of expected inflation) would contribute to 1% fall in loans. The time trend captures the increased role of bank financing in the domestic economy over the years.

Chart 1. Domestic Loans and Economic Growth

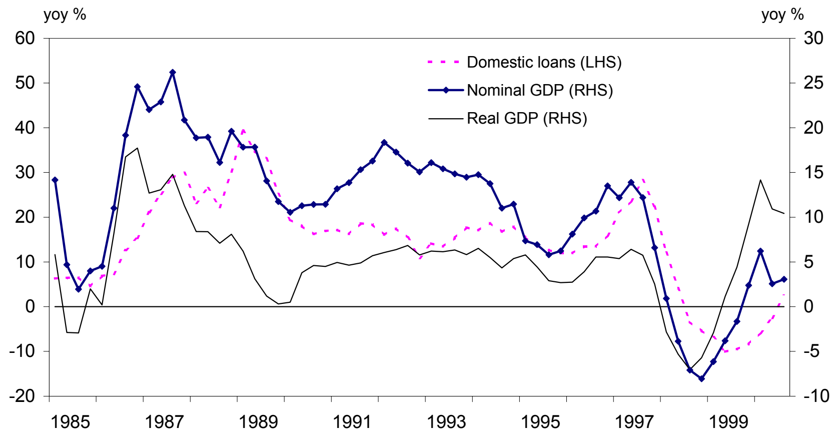
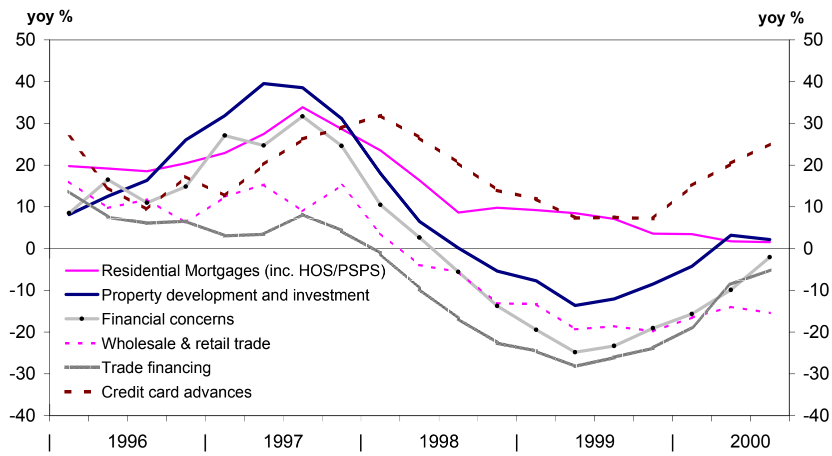


Chart 2. Growth of Domestic Loans by Major Categories



III. FACTORS LEADING TO SLUGGISH LENDING GROWTH

Demand

All the banks we met considered weak demand as the predominant factor behind sluggish loan growth. This was in turn associated with the downturn in the property market, as property-related lending has traditionally been a main driver for both corporate and personal lending. In view of the uncertain prospects for the property market, property developers have refrained from embarking on new large-scale building projects. Consents to commence works, which provide some leading indications for construction activity, have remained at a relatively low level since 1998, though supply of new private residential units is estimated to increase to 30,000 units this year along with the progressive completion of several large residential building projects.

Some banks noted that the balance sheets of property developers were shrinking, as they used the cash proceeds from flat sales to repay their debts. This view is consistent with the financial indicators of listed property companies, which showed a decline in debt-to-equity ratio in 1999 (Table 1).

Table 1. Corporate Financial Indicators

	Property Companies		**Other Listed Companies (excl. banking & finance)**	
	Total assets [1] (HK$ bn)	Debt-to- equity ratio [2]	Total assets [1] (HK$ bn)	Debt-to- equity ratio [2]
1996	14.17	0.55	3.40	1.02
1997	14.71	0.62	3.95	1.01
1998	12.55	0.71	3.66	1.10
1999	12.39	0.64	3.96	0.88

(1) This refers to the average asset size of the companies in the respective categories.
(2) This refers to the aggregate debt-to-equity ratio for companies in the same category.

Source: Primark.

The banks we consulted further pointed out that much of the funding demand from property developers in the past year was for re-financing purpose. Taking advantage of keen competition among banks, many developers re-arranged their revolving credit facility to lock in a more favourable rate. As most banks were willing to waive the commitment fee, the opportunity cost of seeking refinancing was low. Table 2 shows the amount of Hong Kong dollar syndicated loans in the past few years. Although there was a notable increase in 2000, we believe that a considerable proportion of these loans was related to refinancing. In terms of new loans for construction and project financing, there was a notable pick-up in 2000 from the depressed levels in 1998 and 1999, but the amount was still considerably below the pre-crisis level.

Table 2. Syndicated Loans

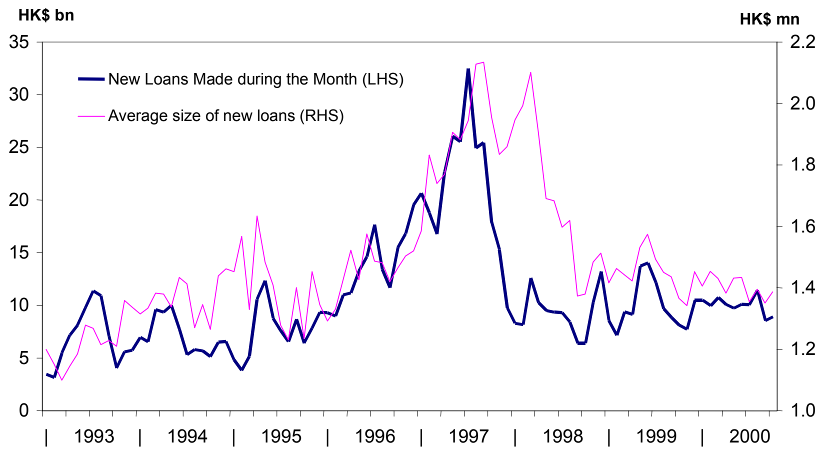
(HK$ bn)

Year	**HK$ syndicated loans arranged**	**Of which: New loans for construction and project financing**
1996	88.4	31.6
1997	158.1	52.9
1998	26.4	8.8
1999	35.9	6.5
2000	112.1	20.1

Source: Basisfield.

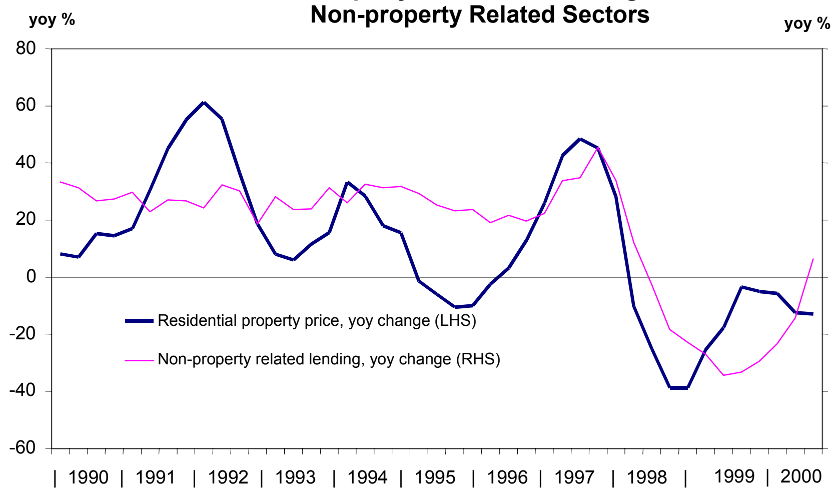
In respect of residential mortgages, banks attributed the sharp moderation in growth to the much lower property values and a significant decline in property market transactions (Chart 3). They noted that many of the new loans were also for re-financing purpose. This is consistent with our statistics which show that refinancing loans accounted for nearly 40% of new loans approved (November 2000 figure).

Chart 3. Residential Mortgage Loans



Some of the banks pointed out that lending to corporations outside the property sector was similarly affected by property prices. The general confidence issue aside, prior to the Asian financial crisis, some of the general- purpose loans might have been used to finance acquisition of premises. As shown in Chart 4, lending to non-property related sectors have been moving fairly closely with property prices since 1996-97. This could also be related to declines in collateral value, which is discussed in the next sub-section.

Chart 4. Property Prices and Lending to Non-property Related Sectors



Notwithstanding media concerns about funding needs of small and medium sized enterprises (SMEs), all the banks we met indicated that they had not seen any significant rise in loan applications from these firms. They believed that SMEs had remained very cautious in their financial management, partly to reduce interest expenses, and partly because the cut-backs of credit lines by banks in 1998-99 were still fresh in their memories.

Supply

Most banks said that they had relaxed their lending policy as general improvement in economic activity had eased concerns about credit risks and strengthened borrowers' financial conditions. This stands in contrast to the situation in 1998-99 when banks cut back lending, as their capital bases were under the pressure of bad debts and credit risks. From 2000 onwards, banks have gradually been relieved from the pressure of non-performing loans. Bad debt charges have reduced from 0.54% of total average assets (annualized) in the first nine months of 1999 to 0.23% in the same period of 2000. The proportion of classified loans and overdue loans has also declined considerably, although it has not yet returned to the pre-crisis level. During the Asian financial crisis, liquidity was also an important concern, as evidenced by intense competition for customer deposits in late 1998. With deposit growth stabilizing at around 4-6% (year-on-year) since mid-1999, this concern faded away. Many banks instead found themselves having excess liquidity.

Against weak demand, banks' willingness to increase supply has resulted in a lowering of loan rates. Such declines have been most evident in respect of lending to residential mortgages and large conglomerates, which are considered less risky. The spread of residential mortgage rates over the best lending rate (BLR) was lowered by around three percentage points, from a high of 1.1% above BLR in early 1998 to 2.0% below BLR in November 2000.[2] Top-tier companies, like Cheung Kong, Hutchison, and Sun Hung Kai, have been able to arrange loan deals at rates of around 40-50 basis points over HIBOR recently, which compared favourably with spreads of over 100 basis points in 1998-99, and were comparable to the pre-crisis spreads (Table 3).

Table 3. Examples of Syndicated Loans Arranged during 1997-2000

Borrower	**Margin over HIBOR (basis points)**	**Date borrowed**	**Maturity (years)**	**Amount (HK$ bn)**
Cheung Kong Finance	45.0	Mar 1997	5	4.0
Hutchison	39.0	Jun 1997	5	12.0
Cheung Kong Finance	100.0	Jun 1998	3	2.2
Hutchison	85.0	Oct 1998	3	2.5
Cheung Kong Finance	95.0	May 1999	3	2.2
Cheung Kong Finance	58.5	Jan 2000	5	2.3
Hutchison	48.5	Aug 2000	5	5.0
Cheung Kong (Holdings)	41.0	Jan 2001	5	3.8

Source: Basisfield & newspaper reports.

[2] The average mortgage lending rates are estimated based on weighted average of the rates for new loans granted each month. Some assumptions are made for the distribution of lending rates.

Notwithstanding a generally easier lending stance, banks appeared to have mixed views on lending to SMEs and Chinese-related entities. One of the local banks we met expressed keen interest in aggressively expanding SME lending. They have recently set up a specialized division to target SMEs. Instead of relying primarily on collateral, more systematic credit assessment based on a wide range of criteria will be introduced. Some other local banks noted that while they had eased their lending towards SMEs by allowing a larger ratio of loan size to collateral value, the amount of lending remained considerably lower than the pre-crisis period due to sharply deflated property value. Some banks have continued to maintain a tight policy over SMEs, in view of the high delinquency rate of this segment during the economic downturn. They also pointed out that most SMEs found it costly to engage big accounting firms to prepare and audit their accounts, making it difficult for banks to ascertain their financial situations.

Most banks believed that lending to mainland-related entities would take some time to recover. But they also noted a greater differentiation among mainland entities, and stronger enterprises had been able to secure deals at favourable rates.

Structural changes

In addition to demand and supply side factors, domestic lending has also been affected by some structural factors, including the availability of renminbi funding, and trading on open account. A number of banks noted that their clients with manufacturing operations in mainland China were now able to seek renminbi funding directly from mainland banks, by pledging their factory premises as collateral or presenting a stand-by letter of credit from Hong Kong banks. This reduces the need to borrow from banks in Hong Kong to finance their operations in the mainland. Manufacturers not only would benefit from the lower renminbi interest rates, but can also avoid currency mismatches as their outlays are largely denominated in renminbi.[3] Banks in the mainland are willing to lend as they are flooded with liquidity, and Hong Kong firms are generally considered as more creditworthy than many of the mainland enterprises. Conceptually, this development should affect “loans for use outside Hong Kong” rather than domestic lending. But according to the banks, it is difficult to classify general-purpose loans according to the place of usage, and in most cases, they have been treated as domestic loans. Financing available from mainland banks is believed to have somewhat reduced the demand for such general-purpose loans.

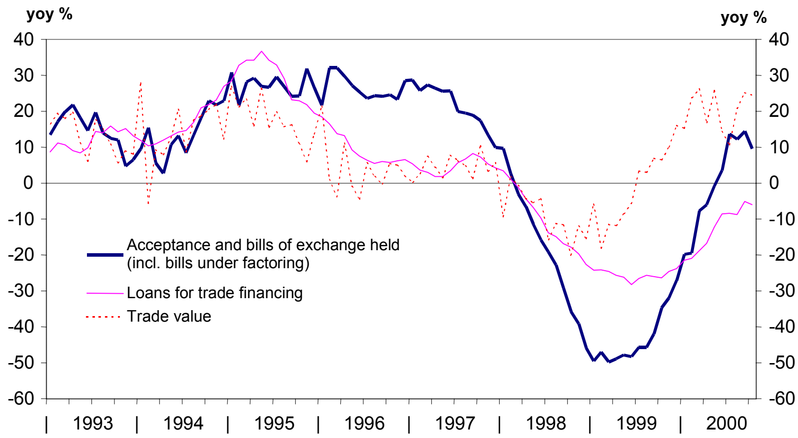
Another major structural change noted by the banks is the increased volume of trade conducted through open account, under which importers would pay directly to the account of exporters, rather than using letters of credit under traditional trade financing. To a large extent, this reflects increased bargaining power of some importers, particularly big department stores in the US. At the exporters’ end, financing can be arranged through discounting the receivables with a bank (known as factoring). By factoring, the bank will assume all the risks associated with the order. It will need to arrange an overseas company to collect payments from the importer. As such, large banks with well-established overseas networks or connections are in a

[3] The official renminbi interest rate for 1-year lending is 5.85% p.a. (and up to 7.6% after adding an allowed margin of up to 30%).

better position to engage in this type of financing. Reflecting higher risks assumed by banks, factoring normally involves deeper discounts than letters of credit in traditional trade financing. An exporter can also arrange export insurance to reduce the risks involved in open account trading.[4] The insurance policy can be discounted with a bank to obtain financing.

While the above developments might have partly accounted for the decline in trade financing loans, banks noted that these alternative forms of financing under open account trading still represent a rather small proportion of total trade financing. Nevertheless, banks' holdings of trade bills, including those discounted under traditional financing as well as factoring, increased notably in the past year, although this reflects in part a reversal from the sharp decline in 1998-99 (Chart 5).

Chart 5. Trade Financing



[4] Trade insurance arranged by the Hong Kong Export Credit Insurance Corporation increased notably by 19% in April-September 2000 over a year ago.

Competition from other sources of financing

Funds raised in the bond and equity markets grew rapidly in the past two years. In particular, funds raised in the equity market in 2000 more than tripled that in 1999 (Table 4). So there arises a question of whether disintermediation reduces the demand for bank lending.

Table 4. Total Fund Raising Activities

(HK$ bn)

Year	New HK$ Corporate Debt Issuance	Funds Raised in HK Equity Market [1]	Increase in Domestic Loans	Total
1996	4.0	100.0	250.4	354.4
1997	12.8	247.6	408.0	668.4
1998	6.2	38.3	-120.6	-76.2
1999	23.2	149.7	-176.1	-3.2
Jan - Nov 2000	14.4	457.8	56.2	528.4

[1] Include H-shares and red chips, and cover IPOs, rights issues, private placement, and funds raised from the GEM.

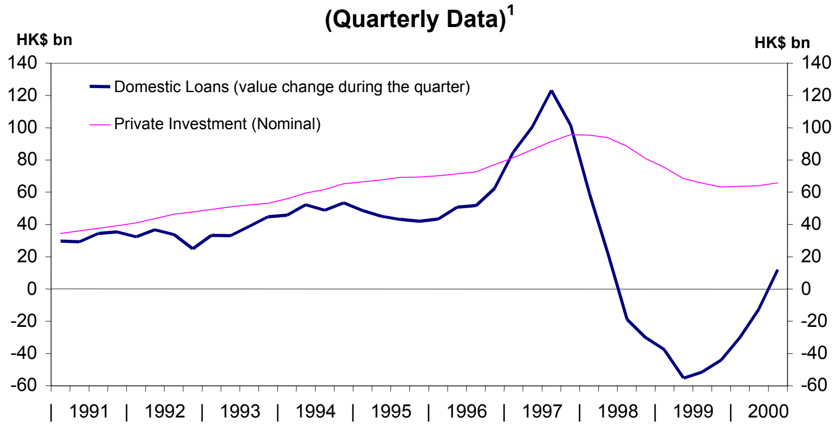
Most of the banks we consulted did not consider equity market financing as a substitute for bank lending. In fact, as much as 75% of funds raised in the local equity market went to mainland enterprises. While local companies also raised a total of $116 billion in 2000, most of these IPOs were launched by firms in the technology sector (the so-called ‘dotcoms’). In the absence of track records, it would be difficult for these firms to apply for bank financing. If they can get off the ground through IPOs, their subsequent investment activities may indeed stimulate demand for bank loans.

Debt market, on the other hand, is perceived as posing a more significant threat to traditional bank lending business. Large conglomerates with good credit ratings have increasingly tapped funds from the debt market, both domestically and internationally. Our statistics show that banks’ holdings of Hong Kong dollar debt instruments increased by $36 billion or 40% in the twelve months to November. In other words, they are indirectly providing funds to corporates through holdings of their papers.

IV. PROSPECTS

The banks were not very optimistic about the near-term outlook of domestic lending business. There are few large-scale investment projects in the pipeline, and big property developers have remained cautious in expanding their balance sheets in view of the uncertain prospects of the property market. We raised the question of whether the recent pick-up in private investment, as shown in the GDP figures, has strengthened loan demand (Chart 6). The banks did not sense any significant surge in loan applications. They believed that a large part of the investment was financed out of retained earnings.

Chart 6. Private Investment and Domestic Loans (Quarterly Data)[1]



[1] Four-quarter moving average.

Banks generally expected competition to remain keen in personal lending, including mortgages, credit card advances, tax loans, as well as other forms of personal lending. The general impression was that growth in mortgage lending would remain modest, while other personal lending would show a more substantial expansion.

In the medium term, most banks considered that the telecommunications sector was a promising growth area. China's impending entry to WTO is also likely to present new investment opportunities to Hong Kong companies, providing new stimulus to lending business as well. However, a couple of banks pointed out that the latest batch of companies rushing into the mainland market were those from OECD countries. They were unlikely to seek financing from banks in Hong Kong. As regards other sectors, one of the banks noted that they would target new growing areas, such as health care. New forms of trade financing (say, factoring) would be further promoted.

VI. CONCLUSION

The discussion with banks suggested that the predominant factor for weak loan growth, as pointed out by all the banks we met, has been subdued demand. This was, in turn, related to balance sheet consolidation of some major borrowers, particularly property developers. On the supply side, banks have generally relaxed their policy as the economy turned around. This has been reflected in a lowering of lending rates. However, in specific sectors, such as lending to SMEs and China-related entities, banks have remained cautious, as high delinquency is still fresh in memory. A few other factors, such as the availability of renminbi funding for corporations with mainland operations, open account trading, and diversification of funding channel, have also contributed to lacklustre loan growth.

Looking ahead, banks expect loan growth to remain moderate in the near term, in the absence of major investment projects in the pipeline. Nevertheless, individual sectors like telecommunications, personal loans, and health care are considered to have good growth potential in the medium term. Also, China's prospective entry to WTO is perceived as a positive factor that will bring along new investment opportunities and loan demand.